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SURFACE TRANSPORTATION BOARD

DECISION

Docket No. EP 664 (Sub-No. 3)

REVISIONS TO THE COST-OF-CAPITAL COMPOSITE RAILROAD CRITERIA

Decided: October 17, 2017

AGENCY: Surface Transportation Board.

ACTION: Final Rule.

SUMMARY: The Surface Transportation Board (STB or Board) is adopting a final rule to update one of the screening criteria used to create the "composite railroad" for the Board's annual cost-of-capital determination. This final rule will require a company's stock to be listed on either the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (NASDAQ), rather than on either the NYSE or American Stock Exchange (AMEX), as the AMEX no longer exists.

DATES: This rule is applicable on November 24, 2017.

FOR FURTHER INFORMATION CONTACT: Amy C. Ziehm, (202) 245-0391. Assistance for the hearing impaired is available through the Federal Information Relay Service (FIRS) at (800) 877-8339.

SUPPLEMENTAL INFORMATION: As one of its regulatory responsibilities, the Board determines annually the railroad industry's cost of capital.[1] The cost-of-capital figure represents the Board's estimate of the average rate of return needed to persuade investors to provide capital to the freight rail industry. The cost-of-capital determination is one component used in evaluating the adequacy of railroad revenues each year under the procedures and standards mandated by Congress in the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (1976) and promulgated in Standards for Railroad Revenue Adequacy, 364 I.C.C. 803 (1981), modified, 3 I.C.C.2d 261 (1986), aff'd sub nom. Consol. Rail Corp. v. United States, 855 F.2d 78 (3d Cir. 1988). The cost-of-capital finding is also an essential component of many other Board regulatory proceedings.

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[1] The cost of capital is calculated as the weighted average of the cost of debt and the cost of equity, with the weights determined by the railroad industry's capital structure (the fraction of capital from debt or equity on a market-value basis). See Methodology to be Employed in Determining R.R. Indus.'s Cost of Capital, EP 664, slip op. at 6 (STB served Jan. 17, 2008).

The Board determines the railroad industry's cost of capital for a "composite railroad," which is based on data from a sample of railroads. Pursuant to Railroad Cost of Capital—1984, 1 I.C.C.2d 989 (1985), the sample includes all railroads that meet the following criteria:

- The company is a Class I line-haul railroad;
- If the Class I railroad is controlled by another company, the controlling company is primarily a railroad company and is not already included in the study frame;[2]
- The company's bonds are rated at least BBB by Standard & Poor's and Baa by Moody's;
- The company's stock is listed on either the NYSE or the AMEX; and
- The company has paid dividends throughout the review year.

1 I.C.C.2d at 1003-04; see also R.R. Cost of Capital—2015, EP 558 (Sub-No. 19), slip op. at 3 (STB served Aug. 5, 2016).

On April 18, 2017, the Board issued a Notice of Proposed Rulemaking (NPRM) that proposed to update the fourth screening criterion used to create the "composite railroad" for the Board's annual cost-of-capital determination. Specifically, the Board proposed that its fourth screening criterion be modified to require a company's stock to be listed on either the NYSE or the NASDAQ, rather than on either the NYSE or AMEX, as the AMEX is no longer in existence. See NPRM, slip op. at 1-2.

The Board sought comments on the NPRM by May 18, 2017, and replies by June 19, 2017. The Board received comments on the proposed rule from the Association of American Railroads (AAR) and the Western Coal Traffic League (WCTL). No reply comments were filed. After consideration of the comments received, the Board is adopting the rule proposed in the NPRM as a final rule.

Comments

In its comments, AAR states that it is supportive of the Board's proposal to update the "composite railroad" screening criteria to better reflect the current state of the marketplace. (AAR Comment 2.) AAR requests that the Board move expeditiously to adopt the proposed rule and prohibit any party from expanding the scope of this proceeding by offering proposals that would "manipulate" the cost-of-capital process. (Id.)

[2] A company is considered to be primarily in the railroad business if at least 50% of its total assets are devoted to railroad operations. R.R. Cost of Capital—1984, 1 I.C.C.2d at 1003-04.

WCTL generally supports the Board's proposed rule and states that expanding the screening criteria to include NASDAQ-listed companies, i.e., CSX Corporation (CSX),[3] would result in a larger composite sample. (WCTL Comment 1-2.) WCTL, however, argues that the "composite railroad" sample is still rather small, consisting of just four companies—CSX; Kansas City Southern Corporation (KCS); Norfolk Southern Corporation (NSC); and Union Pacific Corporation (UPC)—that have significant differences. (Id. at 2.) WCTL also notes that the composite sample omits BNSF Railway Company (BNSF)—which, it asserts, is by some measures the largest railroad in the United States—because BNSF constitutes less than 50% of the assets of its parent company, Berkshire Hathaway. (Id.) According to WCTL, by including CSX in the composite sample (but omitting BNSF), the industry average cost of capital reflects roughly 59% western and 41% eastern railroads, even though in actuality western railroads—UPC, BNSF, and KCS—account for 73% of the industry, and the two eastern railroads—CSX and NSC—account for only 27%. (Id.)[4] WCTL argues that excluding CSX, along with BNSF, from the composite sample would actually result in an average that is more representative of the regional division (75% western and 25% eastern). (Id.) WCTL asserts that the Board's proposed rule could result in an average that is less representative of the industry as a whole, and a cost-of-capital figure that is more distorted. (Id. at 2-3.) Additionally, WCTL states that a "complicating factor" is that the second stage of the Board's Multi-Stage Discounted Cash Flow model (MSDCF) uses a simple average of the growth rates of the individual carriers, such that KCS counts just as much as UPC. (Id.)

Despite its criticisms, WCTL recommends that the Board adopt the proposed rule, but "on a tentative or qualified basis that would allow the Board to revisit the matter, and allow parties to present relevant evidence, if inclusion of NASDAQ-traded carriers turns out to undermine the representativeness of the composite sample, or the accuracy of the cost-of-capital" figure. (Id.)

Summary of the Final Rule.

To reflect the current marketplace, the Board will adopt the changes proposed in the NPRM and now require, as its fourth screening criterion, that a company's stock be listed on either the NYSE or the NASDAQ. Commenters generally support the Board's proposed rule and agree that the NASDAQ is a suitable replacement for the AMEX in the cost-of-capital determination. As noted in the NPRM, when the Board's predecessor adopted the fourth screening criterion, it did so to "insure the availability of stock price data." R.R. Cost of Capital—1984, 1 I.C.C.2d at 1004. By requiring applicable carriers to trade on either the NYSE or the NASDAQ, the Board will continue to ensure the availability of stock price data for use in the Board's computation of the rail industry's cost of capital.

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[3] In the Board's cost of capital calculation for 2016, the Board waived its requirement that a company's stock be listed on either the NYSE or the AMEX, noting that CSX Corporation transferred its stock exchange listing from the NYSE to the NASDAQ in 2015. R.R. Cost of Capital—2016, EP 558 (Sub-No. 20), slip op. at 2 n.4 (STB served Aug. 7, 2017).

[4] WCTL's figures appear to be percentages of the total market capitalization of the railroad industry.

Although WCTL supports the Board's proposed rule and states that expanding the screening criteria to include NASDAQ-listed companies, i.e., CSX, would result in a larger composite group, it argues that the Board's proposed rule could result in an average cost-of-capital figure that is less representative of the regional division of rail assets than it is now. The Board, however, is unpersuaded by WCTL's argument. The purpose of including only carriers listed on particular stock exchanges in the "composite group" is to ensure the availability of stock price data for the annual cost-of-capital determinations for carriers that satisfy the other criteria. See R.R. Cost of Capital—1984, 1 I.C.C.2d 989, 1004 (1984). Here, there is no debate that CSX meets the other criteria and that NASDAQ is a reliable source of stock price data. Excluding a carrier that meets the other criteria and has a reliable source of stock data, in an effort to achieve a "balance" between eastern and western carriers, is unwarranted.

In any event, railroads operating in different parts of the United States may confront different markets, traffic mixes, densities, and topography. As a consequence, there are differences in the cost structures of eastern and western carriers. These physical and cost structure differences, however, do not imply variances in the cost of capital on a regional basis. Investors deploy capital around the world, looking to obtain the highest possible return, while incurring the lowest possible risk. WCTL has not provided evidence to demonstrate that there is any difference in the rate of return investors demand—i.e., the cost of capital—when investing in eastern and western rail carriers. Therefore, the Board believes that it is better to include CSX in the composite-industry cost of capital, as it was in previous years when it was listed on NYSE, to ensure a larger sample size.

With respect to WCTL's argument that another "complicating factor" is that the second stage of the Board's MSDCF uses a simple average of the growth rates of individual carriers, such that KCS counts as much as UP, the Board finds such an argument to be outside the scope of this proceeding. The core issue here is whether, for purposes of the cost-of-capital calculation, it is appropriate to replace a defunct stock exchange (AMEX) with a stock exchange in current and prevalent use (NASDAQ). WCTL's growth rate argument does not relate to that issue and is a collateral attack on other components of the Board's approved methodology.

Finally, the Board declines WCTL's request to adopt the final rule on a conditional or tentative basis, purportedly to allow parties to present additional evidence after implementation. If parties have concerns in the future that inclusion of NASDAQ-traded carriers ultimately results in a less representative composite sample, they may file a petition for rulemaking to modify or revisit the composite group criteria regulation.

Regulatory Flexibility Act Statement.

The Regulatory Flexibility Act of 1980 (RFA), 5 U.S.C. §§ 601-612, generally requires a description and analysis of new rules that would have a significant economic impact on a substantial number of small entities. In drafting a rule, an agency is required to: (1) assess the effect that its regulation will have on small entities; (2) analyze effective alternatives that may minimize a regulation's impact; and (3) make the analysis available for public comment. 5 U.S.C. §§ 601-604. Under § 605(b), an agency is not required to perform an initial or final regulatory flexibility analysis if it certifies that the proposed or final rules will not have a "significant impact on a substantial number of small entities."

Because the goal of the RFA is to reduce the cost to small entities of complying with federal regulations, the RFA requires an agency to perform a regulatory flexibility analysis of small entity impacts only when a rule directly regulates those entities. In other words, the impact must be a direct impact on small entities "whose conduct is circumscribed or mandated" by the proposed rule. White Eagle Coop. Ass'n v. Conner, 553 F.3d 467, 478, 480 (7th Cir. 2009). An agency has no obligation to conduct a small entity impact analysis of effects on entities that it does not regulate. United Distrib. Cos. v. FERC, 88 F.3d 1105, 1170 (D.C. Cir. 1996).

In the NPRM, the Board already certified under 5 U.S.C. § 605(b) that the proposed rule would not have a significant economic impact on a substantial number of small entities within the meaning of the RFA. The Board explained that a change in the listing requirement for inclusion in the composite railroad would not have a significant economic impact on the railroads included; likewise, the Board articulated that, whether or not a railroad would be included in the composite group would have no significant economic impact on that individual railroad. A copy of the NPRM was served on the U.S. Small Business Administration (SBA).

The final rule changes one of the criteria for a railroad's inclusion in the data sample that the Board uses to calculate the annual cost of capital. By definition, that group of railroads is limited to Class I carriers, which are not small businesses under the Board's definition for RFA purposes.[5] Thus, the rule does not place any additional burden on small entities. Therefore, the Board certifies under 5 U.S.C. § 605(b) that the final rule will not have a significant economic impact on a substantial number of small entities within the meaning of the RFA. A copy of this decision will be served upon the Chief Counsel for Advocacy, Office of Advocacy, U.S. Small Business Administration, Washington, DC 20416.

It is ordered:

1. The final rule described above is adopted and will be effective on November 24, 2017.

2. Notice of the rule adopted here will be published in the Federal Register.

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[5] Effective June 30, 2016, for the purpose of RFA analysis for rail carriers subject to our jurisdiction, the Board defines a "small business" as a rail carrier classified as a Class III rail carrier under 49 CFR pt. 1201 § 1-1. See Small Entity Size Standards Under the Regulatory Flexibility Act, EP 719 (STB served June 30, 2016) (with Board Member Begeman dissenting). Class III carriers have annual operating revenues of $20 million or less in 1991 dollars, or $35,809,698 or less when adjusted for inflation using 2016 data. Class II carriers have annual operating revenues of less than $250 million in 1991 dollars or $ less than $447,621,226 when adjusted for inflation using 2016 data. The Board calculates the revenue deflator factor annually and publishes the railroad revenue thresholds on its website. 49 CFR pt. 1201 § 1-1.

3. A copy of this decision will be served upon the Chief Counsel for Advocacy, Office of Advocacy, U.S. Small Business Administration.

4. This decision is effective on the date of service.

By the Board, Board Members Begeman and Miller.